The Role of Central Fiscal Capacity in connecting the EU's Domestic and Global Agendas

The EU's domestic and international agendas are usually discussed in different fora and follow separate tracks. Given the fallout from the Covid crisis and the dramatic consequences of the Russian invasion of Ukraine, this paper argues that the EU's agendas should eventually merge. A central fiscal capacity is a key element for reconciling the EU's domestic and international goals. Domestically, it would help to achieve a balanced policy mix and ensure an adequate supply of European public goods, and globally it would give credibility to the geo-economic role of the EU.

Authors: Marco Buti | Head of Cabinet of European Commissioner Paolo Gentiloni
Marcello Messori | Poste Italiane Chair on European Economic Governance, Department of Economics and Finance, LUISS (Italy)

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1. Introduction

The debate on the geo-economic role of the European Union (EU) is encapsulated in the "Open strategic autonomy" formula, as defined by the Commission (see, i.e., European Commission 2021); hence, it has mainly taken place in the realm of foreign policy and, as far as technological innovations and supply-chain issues were concerned, in the realm of industrial policy. In parallel, the debate on economic policy coordination in the wake of the EU response to the pandemic has been centred on the implementation and the future evolution of Next Generation-EU (NGEU). It has mainly addressed the challenges in delivering the reform and investment commitments under the Recovery and Resilience Facility (RRF), the implications for the policy mix of a temporary or permanent central fiscal capacity, and the supply of European Public Goods (EPGs) (see Buti and Papacostantinou 2022, Garicano 2022, and Maduro *et al*. 2021). *De facto*, the two debates have so far followed separate avenues.

We argue in this paper that these separate tracks should eventually merge: the EU's possible role in international governance and its internal economic policy coordination should be looked at jointly. This approach is supported by strong arguments, at the micro- and macro-economic level. The NGEU's focus on the "triple transition" – green, digital, and social – is directly influenced by the EU's actual and potential geo-economic role; the latter role depends on the re-affirmation of the EU's traditional areas of strength (environmental compatibility, regulation, and welfare system) and on addressing its economic and institutional gaps (digital innovations and security).

The intrinsic links between the EU's international and domestic roles are now dramatically strengthened by the Russian invasion of Ukraine. In the likely long phase of the geo-political tensions, it will be impossible for the EU to pursue a sustainable economic and social reform strategy without combining Europe's traditional features, the diffusion of the new technologies within the area and the adoption of a security system as an EU public good. In the present juncture, the call for mutual support of the EU's domestic and international agendas acquires a wholly new meaning and becomes even more cogent.

In the following, we explore the main challenges that are related to the EU's internal and external ambition and to the consequences of the EU's reaction to its domestic and global agenda (Section 2). This analysis leads to the conceptualisation of the links and incompatibilities of the EU's domestic and international strategies by means of a "geo-economic trilemma" (Section 3). The potential features of a central fiscal capacity aiming at reconciling domestic and international objectives are discussed in Section 4. The final section concludes.

2. The challenges of the EU's domestic and global agendas

It is well known that the EU suffers severe qualitative lags towards the USA and China in terms of digital transformation and artificial intelligence and in terms of security, whilst showing strength in terms of 'green' transition, welfare state, and regulation (see Buti and Messori 2021b). The EU's position in international governance would be improved if European countries were able to effectively meet the decarbonisation goals agreed by the EU. The newly adopted climate package 'Fit-for-55' would reduce the EU's technological gaps, strengthen its current environmental advantages, and ease the reform of its welfare systems to ensure a high level of social inclusion in the new technological and 'green' setting. NGEU and its main programme, the RRF, are the centralised fiscal initiatives agreed by the EU in 2020 to achieve these objectives. The successful implementation of the RRF and the production of EPGs are eased by appropriate macroeconomic policies and require a microeconomic strategy.[1]

From a macroeconomic standpoint, an appropriate aggregate fiscal stance is needed to avoid overburdening the ECB's role and to overcome the 'fiscal dominance' and 'financial dominance' that characterised the period 2014–2018 in the euro area (see Buti and Messori 2021a; Benigno *et al.* 2021). Moreover, confirming the experience of the previous decade, the pandemic shock has showed that it would be very hard to achieve an adequate fiscal stance solely by means of the coordination of national fiscal policies. Hence, the combination of an adequate monetary policy and an aggregate fiscal policy stance, with a centralised fiscal tool at its core, is crucial to achieve a balanced policy mix. An expansionary fiscal policy stance, including central fiscal support, has prevented the exchange rate and external demand from becoming the sole adjustment valve for the Euro-Area (EA) countries in the 2021 rebound from the 2020 pandemic shock, thereby avoiding national free-riding behaviour. It becomes even more important in the case of 'existential' shocks, such as the resurgence of Covid-19 or the economic consequences of the Russian invasion of Ukraine and the new geo-political tensions, which affect the supply as well as the demand side of the EU economy. In both cases, the shock is exogenous, symmetric in origin but asymmetric in outcome. Hence, it justifies a joint response with the support focused on countries hit the most.

From a microeconomic standpoint, as Buti and Papacostantinou (2022) argue, there is an unfulfilled demand for EPGs that must be financed and delivered at the EU level and cannot be achieved by the mere aggregation of national projects. Several of these 'pure' EPGs (from the joint public procurement of vaccines to investment in hydrogen energy, or from the construction of a European telecommunication

[1] As in Buti and Papacostantinou (2022), we use a pragmatic definition of 'pure' EPGs, namely those that are financed and delivered at EU level. In the literature on public economics, public goods are defined as goods that are 'non-rival' and 'not excludable'. This means that the utilisation of a pure public good by an economic agent does not reduce the possibility of an analogous utilisation by others, and that any exclusion from the access to the same good is inefficient (too costly). It is worth noting that, in principle, our pragmatic definition is compatible with these more formal features. However, a well-founded application of the 'non-rivalry' and 'non-excludability' principles to the EU functioning would require further analysis.

network to the joint production of semiconductors) are key to trigger positive externalities in the European single market and to boost the EU's soft role of 'attractor' for third countries on the international scene. NGEU and the RRF represent progress in this direction. However, due to their redistributive aim, they can at best produce EPGs 'by aggregation' of national projects responding to EU priorities and much less supply 'pure' EPGs.

These considerations show the strong links between the macroeconomic and the microeconomic aspects, and confirm, as it is widely acknowledged, that NGEU represents a major policy breakthrough (see Buti 2021, Messori 2021). The RRF prescribes that at least 37% and 20% of the European funds should be allocated to the 'green' and digital transition, respectively. This double transition will have an impact on the labour market's equilibria and on the human resources' skills, which will require increases in social expenditures and a welfare reform. Therefore, the correct way of addressing these challenges is to think in terms of a 'triple transition' - green, digital, and social.

An efficient use of the RRF could support reforms as well as public and private investments at the national level in the period 2022-2026. Moreover, its achievement could ease the convergence between member states. The RRF would thus provide a set of tools to improve the post-pandemic effectiveness of the rules-based economic coordination that the EU has built since the late 1990s. Moreover, it could strengthen the interaction between the temporary centralised fiscal policy and the national fiscal policies, thus defining a "space of vertical coordination" which would open the way to the gradual construction of a long-term central fiscal capacity (see Buti and Messori 2021a). The success of NGEU and the related gradual build-up of a permanent fiscal capacity at the EU level could be combined with more credible common fiscal rules. As argued by Amato *et al.* (2021), the 'RRF methodology' that has resulted in new relations between the individual countries and the EU institutions should be of inspiration for the reform of the fiscal rules during the transition.

The challenges of creating a permanent central fiscal capacity are not only political, but also legal. As shown by Tosato (2021) and Maduro *et al.* (2021), NGEU's architecture and the related issuance of European debt are based on a temporary construction outside the EU multiannual framework, justified by an extraordinary event (the pandemic). Hence, a repeated feeding of a central fiscal capacity beyond 2026 could be only justified by a new and extraordinary emergency. Sadly, the recurrence of dramatic shocks (the war in Ukraine) and the likely perspective of a long-lasting geo-political tensions risk transforming the emergency into the 'new normal' of the years to come.

3. The EU's geo-economic trilemma

The ascertainment that the NGEU does not mechanically imply the gradual building of a permanent fiscal capacity at the European level raises the question of whether this capacity is indispensable for progress in the EU's economic governance. Moreover, the answer to this question would require urgency if we were right in maintaining that the new fiscal rules can be shaped on the RRF's methodology.[2] Thus, in this section we aim to show that it would be impossible to overcome the geo-economic trilemma without recourse to a permanent and centralised fiscal capacity.

Figure 1 highlights the EU's geo-economic trilemma: the EU cannot have – at the same time – an effective role in global economic governance, a rules-based coordination framework, and no central fiscal

[2] As stated above, Amato *et al.* (2021) propose to use the RRF methodology as a basis for shaping the new European fiscal rules.

capacity. From a policy point of view, this incompatibility is equivalent to stating that the EU cannot strengthen its role in global economic governance and, at the same time, coordinate fiscal policies simply based on a “proscribing” system of rules without recourse to a central fiscal capacity.

INSERT FIGURE 1

As indicated in Figure 1, the trilemma can be solved via each one of its three sides connecting the different “corners” of the triangle.

Combination (a) is the one that *de facto* prevailed during the first two decades of the EA. In absence of a central fiscal capacity, the attempt to implement rules-based coordination resulted in the current account balance becoming the adjustment variable. This was particularly evident immediately after the global financial crisis, when the EA moved from a broadly balanced external position to a persistent current account surplus, thereby exporting recession to the rest of the world. Throughout that period, the EU fell prey to its ‘small country syndrome’ and to a ‘reverse creditor paradox’ that weakened its role in global governance (Buti, 2021, chapter 35).

During the first decade of the monetary union, the EA growth led to an increase of member states’ convergence within the area. However, much of the improvement in economic performance during that period was due to the cross-balancing between a positive net export of ‘core’ countries and financial inflows towards fragile countries within the area. As shown by the reaction to the international crisis and to the related EA crises (2010-2013), the rules-based economic coordination without central fiscal capacity was unable to efficiently handle the negative shocks. The EU largely intergovernmental coordination, centred on a tighter Stability and Growth Pact (Six and Two Pack, Fiscal Compact), led to insolvency problems in the European banking sector, the weakening of the social protection systems, and, especially in Southern member states, negative net public investment. This went hand in hand with the marginalisation of the EU’s role in pushing forward the frontier of technological innovations and diffusion. To limit these drawbacks and avoid further disruptive impacts of fiscal constraints, European institutions overburdened the ECB’s role (Securities Market Programme, Longer-Term Refinancing Operations, Outright Monetary Transactions, and various forms of ‘quantitative easing’), thereby resulting in ‘fiscal dominance’ (Buti and Messori 2021a). Moreover, a number of EA members tried to protect their short-term positions in international markets by increasing their net export instead of strengthening their domestic demand (the other side of aggregate investment lower than aggregate savings).

Despite the absence of a central fiscal capacity in combination (a), to reduce the short-term instability and the medium-long term risk of breakdown in the euro area, European institutions were obliged to build centralised tools of crisis management (the European Financial Stability Facility and the European Financial Stabilisation Mechanism, and then the European Stabilty Mechanism) and of financial coordination (the two pillars of the Banking Union, and the Capital Markets Union). These tools can be seen as evidence that some form of central fiscal and financial capacity is needed, at least in terms of a last-resort intervention.

Differently from combination (a), combination (b) aims at ensuring an international role for the EU. However, this last combination attempts to achieve an adequate aggregate fiscal stance purely by means of horizontal coordination of national fiscal policies, that is, giving up any rules-based coordination. As the experience of the years preceding the pandemic shock shows (2016-2018), it is very hard to convince member states to implement national policies for the sake of the EU or EA fiscal policy stance. On the one hand, there is the risk that some EU member states implement non-coordinated and overly restrictive national fiscal policies to comply with a supposed 'market discipline', thus overburdening the ECB's monetary policy. On the other hand, other member states may pursue overly expansionary national fiscal policies, thus triggering free-riding behaviour towards their partners. In both cases, the result leads to uncooperative solutions in which an adequate policy stance occurs too late and by chance and, most likely, via the wrong distribution of national fiscal stances.

The only combination that aims at ensuring a role for the EU in global governance and preserving a rules-based system is (c). However, at the macroeconomic level, the absence of a central fiscal capacity in this last combination makes it harder to pursue an adequate fiscal stance for the most fragile countries and to avoid free riding on third partners' demand for the 'core' countries. Moreover, at the microeconomic level, the lack of a central fiscal capacity makes it inconvenient to carry out those risky investments in advanced technologies and in the green transition, which are essential to foster the EU's role of 'attractor' on the global scene (Buti and Messori 2021b). The result is close to combination (a). Even combination (c) is very likely to reduce the international dimension of the EU to trade competitiveness and to the accumulation of positive and growing flows of net export. As a side-effect of this export-led growth, the EU economy increases its dependence on external imports of energy, foods and other raw materials which are a source of vulnerability, as shown by the current impact of the Russian invasion of Ukraine.

The analysis of the three combinations illustrated in Figure 1 confirms that, as experienced during the pandemic shock and as strengthened by the war in Ukraine, it will be impossible to implement an active fiscal policy at the EU or EA level if countries are constrained to adjust their national policies in compliance with a rules-based fiscal stance or market discipline in absence of a central fiscal capacity.

4. Revisiting the roles of an EU central fiscal capacity for domestic and international purposes

As shown by the initiatives taken by the Commission and other European institutions since March 2020, any exit-strategy from the economic recession and any initiative to relaunch the international role of the EU have required an 'escape clause' with respect to the EU's fiscal rules and the recourse to a central fiscal action, even one of a temporary nature. In this respect, NGEU has been the best but not the only example. The policy mix implemented by the EU in the years 2020-2021 was different from that pursued in the periods 2011-2014 or 2016-2017. Even though the already expansionary monetary policy has been further strengthened since mid-March 2020 (most notably via the Pandemic Emergency Purchase Programme, PEPP), the ECB's monetary policy has ceased to be "the only game in town" (El-Erian 2016). The ECB's unconventional monetary policy and asset purchase programmes, together with the positive confidence shock due to the adoption of NGEU, have allowed for expansionary national fiscal policies even in the EA member states with an otherwise limited fiscal capacity. Therefore, the EU has been able to design a strategy of economic and social development aimed at strengthening its role in the international market as well as its stability and cohesion within the area.

If one agrees with the conclusion that a central fiscal capacity has the potential to rebalance the policy mix and boost the geo-economic role of the EU, the next question will become what this kind of fiscal capacity should do. As discussed in Buti and Messori (2021b), a permanent fiscal capacity could take three forms: a central stabilisation function, the supply of EPGs, and the support for national reforms (akin to the Contractual arrangements proposed by the then President of the European Council in 2013, Herman van Rompuy). Table 1 presents, in a summarised fashion, the implications on the domestic and international agendas of these three options.

INSERT TABLE 1

The first option, that is, the central fiscal capacity as a cyclical stabilisation tool, would complement the ECB's monetary policy and national fiscal policies, notably of the EA, in response to symmetric as well as country-specific shocks. The ensuing more balanced policy mix would lower the dependence on external demand, and hence it would allow the EA to rely less on the role of the euro exchange rate or on price competitiveness as a channel of adjustment, which are potential factors of friction with international partners and with the other countries of the area. The second option is centred on the improved supply of EPGs, especially those financed and delivered at EU level that Buti and Papacostantinou (2022) dub "pure" EPGs. This would help foster the triple transition, thereby rebalancing NGEU by bringing it back to the Commission's initial proposal in May 2020 that had foreseen a stronger role in delivering EU priorities, compared to the member states transfers as eventually decided by the European Council. It would also strengthen the capacity to act in non-economic areas (e.g., health and security).[3] The credibility in bridging the technological gap vis-à-vis the USA and China and fostering the green transition will boost the role of the EU as 'attractor' on the international scene and give credibility to the goal of 'open strategic autonomy'. The third option (EU support for national reforms) would boil down to reviving the proposal of 'contractual arrangements' made in 2013 by the then President of the European Council, Herman van Rompuy. It would help build trust and increase potential growth and resilience, thus enhancing economic dynamism with favourable effects both domestically and internationally.

Figure 2 presents, in a schematic fashion, the impact of the three central fiscal capacity's options on actual (Y) and potential (Y^*) output, under the simplified assumption that the starting point is a zero-output gap. It seems reasonable to assume that boosting the supply of EPGs (namely those of economic nature) would increase both actual and potential output. Hence, investing in EPGs would shift the economy from point A to point B. In absence of an accompanying demand boost, a central fiscal capacity that promotes structural reforms would increase potential output more than actual output; hence, at least in the short term, the output gap would become negative (from B to C). A central stabilisation function would help bring back actual output towards potential output (from C to D), mainly by sustaining aggregate demand at national and European level.

INSERT FIGURE 2

From the discussion above it emerges that the central fiscal capacity, in order to improve the internal economic coordination and to boost the international role of the EU, would ideally fulfil all three roles. This is clearly a tall order and appears to be politically out of reach of the EU, at least in the foreseeable future. As in many other areas, the EU will have to acknowledge that it operates in a second-best environment. If currently the EU does not have the 'political capital' to set up a multi-dimensional central fiscal capacity able to fulfil the three functions outlined above, where should it start? Taking into account political feasibility, the impulse to subsequent steps, and coherence with evolving short-term strategic priorities, investments in EPGs that relate to the areas of digital innovations, health, sustainable energy,

[3] We are aware that the areas of health and security have indirectly strong impacts on economic innovations and activities. Nevertheless, their main objectives go beyond the economic field.

and security appear to be the most appealing avenue at the current juncture. This would mean an extension of the already defined RRF set-up, adding to the strategic areas of EU public spending on health and security.

5. Looking forward

In this paper, we have argued that a permanent central fiscal capacity is the key element for reconciling the EU's domestic and international agendas. It would help achieve, domestically, an adequate fiscal stance and a balanced policy mix and strengthen, globally, the geo-economic role of the EU.

The economic fallout of the Russian invasion of Ukraine dramatically strengthens the intrinsic links between the EU's international and domestic roles. In the present juncture, the call for mutual support of the EU's domestic and international agendas acquires a wholly new meaning. In the likely long phase of geo-political tensions following the invasion of Ukraine, it will be impossible for the EU to pursue a sustainable economic and social reform strategy and boost its geo-economic role without complementing the traditional European 'soft' power with the delivery of new 'hard' EPGs: a security union.

It follows that an appropriate policy mix becomes even more important as the war in Ukraine is a shock affecting the supply as well as the demand side of the EU economy. The ECB will need to keep inflation expectations in check, and fiscal policies will have to continue investing in the double transition and provide targeted support of low incomes also to reduce the risks of a price-wage spiral. As the ECB has announced, with the gradual phasing out of the asset purchases and its intention to focus on its primary objective of reducing the inflation rate, the fiscal policy side will have an increased responsibility to prevent financial fragmentation. As in the case of NGEU in 2020 and 2021, the announcement of newly found consensus on a central fiscal response would *per se* likely stabilise the markets. Moreover, to the extent that investments in energy policy and infrastructure will be part of the commonly financed plans, the intertemporal consistency between the present measures to stem the impact of higher energy prices and the medium- and long-term objectives of the decarbonisation of the economy will gain in credibility.

In sum, is our call for establishing a permanent central fiscal capacity robust enough to meet the challenges of taming stagflationary risks and complementing the EU's 'soft' geo-economic power with a 'hard' geo-political role? Our answer is yes.

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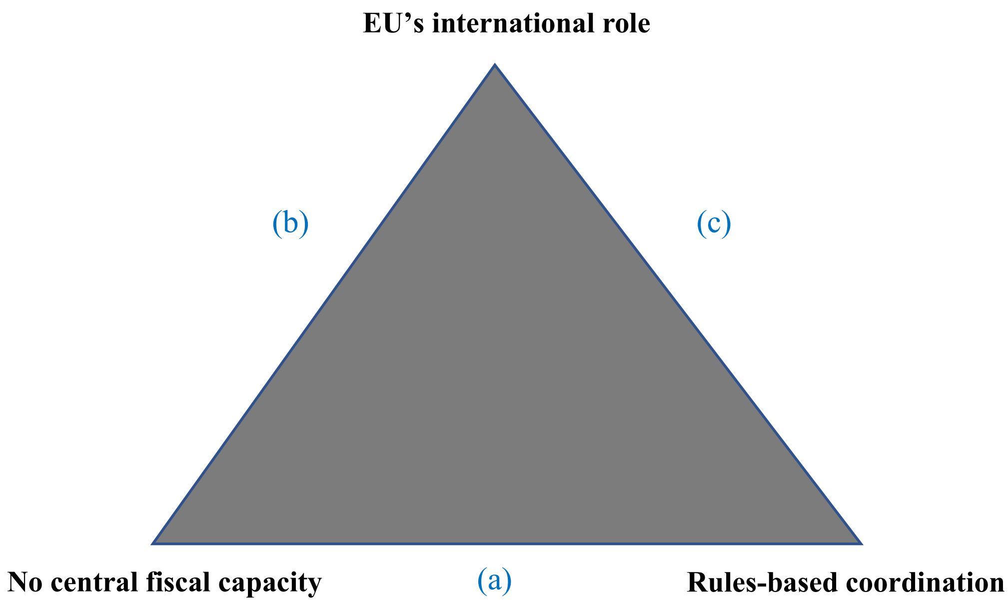
Figure 1: EU's Geo-Economic Trilemma



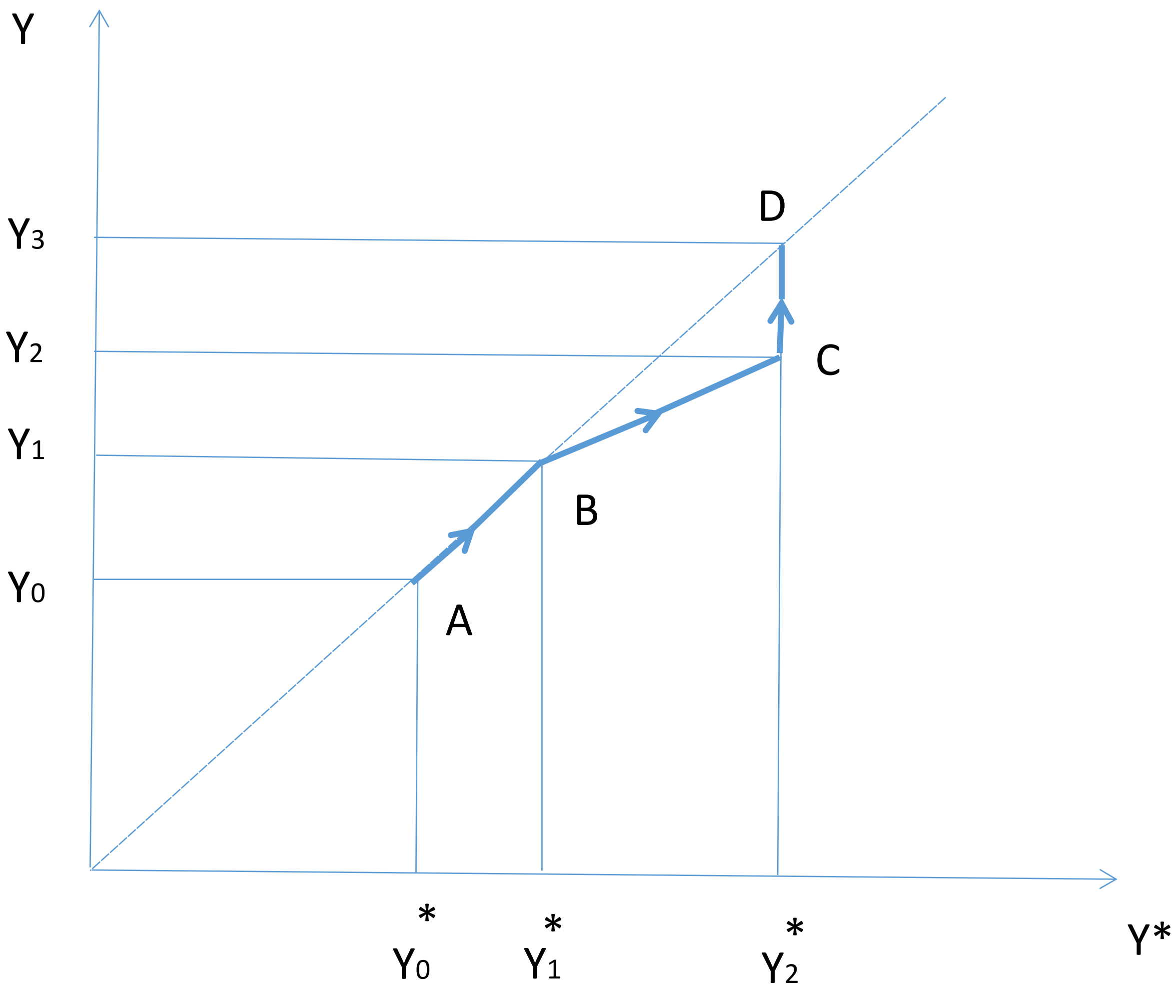
Source: authors' elaboration

Table 1 Central Fiscal Capacity: domestic and international role

Policy goal \ Central fiscal capacity	Stabilisation function	Supply of EPGs	Reform support
Domestic agenda	Complementing monetary policy and national fiscal policies	Foster triple transition in the RRF	Resilience, potential growth
Geo-economic role	Lower dependence on external demand by supporting investment	EU as 'attractor' by reducing technological divide	Dynamism, innovation and protection
Key feature	*EA dimension of stabilisation*	*Foster open strategic autonomy*	*Trust building as essential condition for vertical coordination*

Source: authors' elaboration

Figure 2   Actual and potential output: impact of the three options for a Central Fiscal Capacity



Y_i (i = 0, 1,…, 3) actual ouput, and Y_j* (j = 0, 1, 2) potential output

Source: authors' elaboration